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International Taxation Conference 2010
Mumbai, India

Recent US Developments

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Introduction

- The United States had many important international developments in 2010.
- The international developments that will be summarized relate to:
  - Legislation
  - IRS Structure/Administrative Practice
  - International Cooperation
  - Proposed Legislation

Legislation

- In 2010, there were four separate pieces of legislation that contained provisions important to international transactions.
- The provisions relate to :
  - Economic substance
  - Guarantees
  - The Foreign Account Tax Compliance Act

Economic Substance

- The economic substance doctrine was codified in new IRC section 7701(o), "Clarification of Economic Substance Doctrine.''
- The doctrine codified previous court determinations that the anticipated tax benefits from a transaction should be denied if the transaction does not result in a meaningful change to the taxpayer's economic position other than reducing their tax liability.
- A key component is the codification of the "conjunctive test,'' which holds that the taxpayer must demonstrate that the transaction meaningfully changes his or her economic position and that the taxpayer has a substantial non-tax business purpose for entering into the transaction.
- A 40% penalty on underpayments attributable to non-economic-substance transactions that are not disclosed is imposed. The penalty for disclosed non-economic-substance transactions would be 20%. No exceptions to the penalty would be available (i.e., the penalty would be a strict-liability penalty). Further, the reasonable cause and good faith exception would not apply to any portion of an underpayment that is attributable to a transaction lacking economic substance.

Guarantees

- Legislation has been enacted to determine the source of income from guarantees on indebtedness of a US person by a foreign person.
- Under the legislation, income realized from providing a guarantee to a non-corporate US resident or to a US corporation is characterized as US-source.
- This legislation reverses *Container Corp. v. Commissioner,* in which the Tax Court held that guarantee payments are sourced by reference to the “location” of the guarantor and, therefore, are foreign-source income when paid by a US subsidiary to a foreign affiliate.
  - There was a concern that guarantees to strip income from the United States to foreign affiliates on a tax-free basis.

Guarantee Fees

- Most US income tax treaties do not have specific rules on the treatment guarantee payments, but many include an Other Income provision that governs the treatment of income not otherwise subject to a specific provision in the treaty.
- Some treaties provide an exemption from source country tax on other income.
- This type of provision would likely prohibit US tax on guarantee fees paid by a US subsidiary to a resident of the other treaty country, unless it was associated with a permanent establishment.

Foreign Account Tax Compliance Act

- FATCA, as it is colloquially known, refers to Chapter 4 of the US Internal Revenue Code, which was enacted by the HIRE Act on March 18, 2010. FATCA requires non-US foreign financial institutions (FFIs) and non-US non-financial entities (NFFEs) to identify and disclose their US account holders and members or become subject to a new 30% US withholding tax with respect to any payment of US source income and proceeds from the sale or equity or debt instruments of US issuers (hereinafter referred to as Withholdable Payments).

Why Was FATCA Enacted

- This legislation is a direct result of the focus by the United States (and other industrialized and developing countries) on combating offshore tax evasion and recouping much needed tax revenues.
- The legislation was proposed to remedy perceived deficiencies in the current methods used by the US Internal Revenue Service (IRS) and the US Department of Justice (DOJ) to identify US persons who utilize foreign financial accounts or foreign entities and thereby provide more information to the IRS to enforce compliance.
- The legislation was also prompted by the well-publicized prosecution of a large and well-knows Swiss bank that facilitated US tax evasion.

What is the Purpose of FATCA

- The overall purpose is to detect, deter and discourage offshore tax abuses through increased transparency, enhanced reporting and strong sanctions.[1] The ultimate goal of the legislation is for the United States to obtain information with respect to offshore accounts and investments beneficially owned by US taxpayers rather than to collect any tax through the new withholding regime.

- [1] FATCA also contains other provisions related to US tax compliance that directly impact US taxpayers, which are not discussed herein.

When Will FATCA Become Effective

- FATCA will become effective with respect to payments after December 31, 2012 (subject to a limited transitional rule). The reason for the delayed effective date is to permit FFIs and NFFEs to adapt internal procedures and information technology systems to transition into this new reporting and compliance system regime.

Who Will Be Affected by FATCA

- FATCA will have a direct and profound impact on FFIs that have US proprietary investments, US account holders, or US financial dealings.
- FATCA's impact will be magnified by the cascading of international financial transactions that flow through numerous entities.
- Each time a FFI receives or makes a payment that is a Withholdable Payment, it will be impacted by FATCA. Under US law, an FFI can be treated as a US withholding agent.

How Will Foreign Law Impact Compliance with FATCA

- FATCA is a US-centric law that imposes expansive compliance obligations on FFIs, which are subject to local-centric laws and oversight.
- FFIs are subject to regulatory oversight and laws in their home country and in countries in which they conduct business through branches and subsidiaries.
- FATCA requires that an FFI obtain, verify and transmit information to the IRS, close accounts of certain account holders referred to as Recalcitrant Account Holders and/or collect a 30% US withholding tax on Withholdable Payments made to Recalcitrant Account Holders or non-compliant FFIs.
- Questions will arise whether an FFI will be violating local laws in taking such actions, thereby exposing it to potential regulatory sanctions and potential lawsuits from account holders or others.
- Further, if an FFI has branches in other countries, it may not be possible for these branches to transmit account information to the home office based on constraints of local law in the jurisdiction in which the branch is located.
- These local law constraints may conflict with the implementation of FATCA unless rationalized.

What Options Are Available to FFIs and NFFEs

- FFIs and NFFEs affected by FATCA will have a simple choice to make as to whether they agree to comply with FATCA or not. FFIs and NFFEs that would like to continue to invest on their own behalf or on behalf of clients in the US capital markets will have to agree to comply with the new provisions.
- Those that do not agree to comply with the new provisions will suffer a 30% withholding tax and thus will be unable to compete with those FFIs and NFFEs that are compliant.
- Certain FFIs, rather than incurring the new US withholding tax, may simply choose to cease to hold US securities for their own account and not have US account holders or, alternatively, cease to maintain accounts on behalf of US persons unless they hold only non-US securities.
- Even for those FFIs that cease to have a direct involvement in the United States, FATCA may impact them through the Passthru Payment rule discussed below.
- However, for those FFIs and NFFEs in countries that hold substantial amount of US dollars, engage in significant trade with the US or otherwise want to expand their commercial relationships with the United States, disengaging from the United States capital markets is not an option and it will be necessary to work with the IRS in crafting workable rules to implement and comply with FATCA.

IRS Structure/Administrative Practice

- There are two major developments:
  - The restructuring of the IRS international operations.
  - The requirement for taxpayers to file uncertain tax positions.

IRS Restructuring

- The IRS has reorganized and changed the name of its Large and Mid-Size Business (LMSB) division as part of its ongoing effort to focus more on international tax compliance.
- Starting October 1, the division will be known as the Large Business and International (LB&I) division.
- The reorganization is designed to create a centralized group to handle the IRS' international tax compliance efforts.
- As part of the reorganization, the IRS international program will grow from nearly 600 employees to almost 1,500.
- The new staff will comprise additional examiners, economists and technical staff, most of whom currently focus on international issues in other parts of the LMSB division.
- The international program will include a transfer pricing director and a chief economist.

IRS Restructuring

- The reorganization is the latest evidence of the IRS' recent focus on international tax compliance, which included last year's voluntary compliance program for taxpayers with undisclosed foreign accounts.
- The LB&I division will also handle implementation of changes mandated by the recently enacted Foreign Account Tax Compliance Act (FATCA).

Uncertain Tax Positions

- The IRS recently finalized the requirement that specified categories of corporate taxpayers include information as to "uncertain tax positions" as part of their tax return (Schedule UTP).
- The new reporting requirements apply beginning with returns for 2010.
  - Affected taxpayers include corporations filing Form 1120 and 1120-F that issued audited financial statements (or are included in audited financial statements of a related party) for the tax year and recorded a reserve for one or more US tax positions.
  - The IRS has not specified for failures regarding Schedule UTP.

MNCs Considerations

- UDP reporting applies if a tax reserve is recorded in an audited financial statement of a foreign parent corporation in which the US taxpayer is included and if the tax position was taken on the US taxpayer's return.
- Corporations filing Form 1120-F (to include foreign entities filing protective returns) must complete Schedule UTP if reserves have been established on an audited financial statement for that US tax uncertainty or others. The dollar threshold for filing is based on worldwide assets.
- Transfer pricing positions must be specifically identified. The IRS, after reviewing the utility of the process, may consider requiring additional information such as the specific country or character of income.
- Significantly, the IRS affirmed a general intention to refrain from providing Schedule UTP information to other governments, absent a reciprocal arrangement with the foreign government, and, even then, only after consideration of other factors.

International Cooperation

- Today's increasingly borderless world.
- Growth in international transactions.
- Increased complexity of transactions and tax laws.
- Recent international tax evasion scandals put the spotlight on improving international compliance.
- Economic crisis: ensuring compliance by all taxpayers and collecting all tax legally due.

International Cooperation
Key Developments

- **Key Developments**
  - 2009-2010 saw dramatic expansion of exchange of information networks particularly with offshore jurisdictions.
  - Administrations are moving beyond standard forms of exchange of information (on request, spontaneous, automatic) to other types (*e.g.*, sharing of information about types of tax planning schemes).

Joint Audits

- The IRS Commissioner has announced that joint audit could also provide tangible benefits to tax authorities.
- It can take years to resolve double-tax cases through the Competent Authority process.
- However, if a joint audit could allow us to identify the issue and understand the facts quickly and on a bi- or multi-lateral basis, tax authorities should be able to adjudicate these disagreements right away and reach a resolution through a much more efficient and effective process.
- Tax authorities are moving from just cooperation and sharing of information to the very early stages of planning actual coordinated efforts among countries.
- The OECD Forum of Tax Administrators is developing a guide*; i.e*., a how-to, practical approach that highlights pitfalls to avoid, and possible best practices to employ.
- It will be based on a wealth of country experience in the predecessors to the joint audit: simultaneous exams, bilateral advanced pricing agreements, and mutual assistance agreements, to name some of the more prominent.

Administration's Transfer Pricing Proposals

- Include workforce in place, goodwill, and going concern value in the definition of intangible property for purposes of sections 482 and 367(d).
- In cases of multiple intangible property transfers, the Commissioner could combine the values of the properties on an aggregate basis to achieve a more reliable result.
- The Commissioner could also value intangible property taking into consideration the prices and profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction undertaken.
- If a US person transfers an intangible from the United States to a related controlled foreign corporation that is subject to a low foreign effective tax rate in circumstances that evidence excessive income shifting, then an amount equal to the excessive return would be treated as subpart F income in a separate foreign tax credit limitation basket.

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